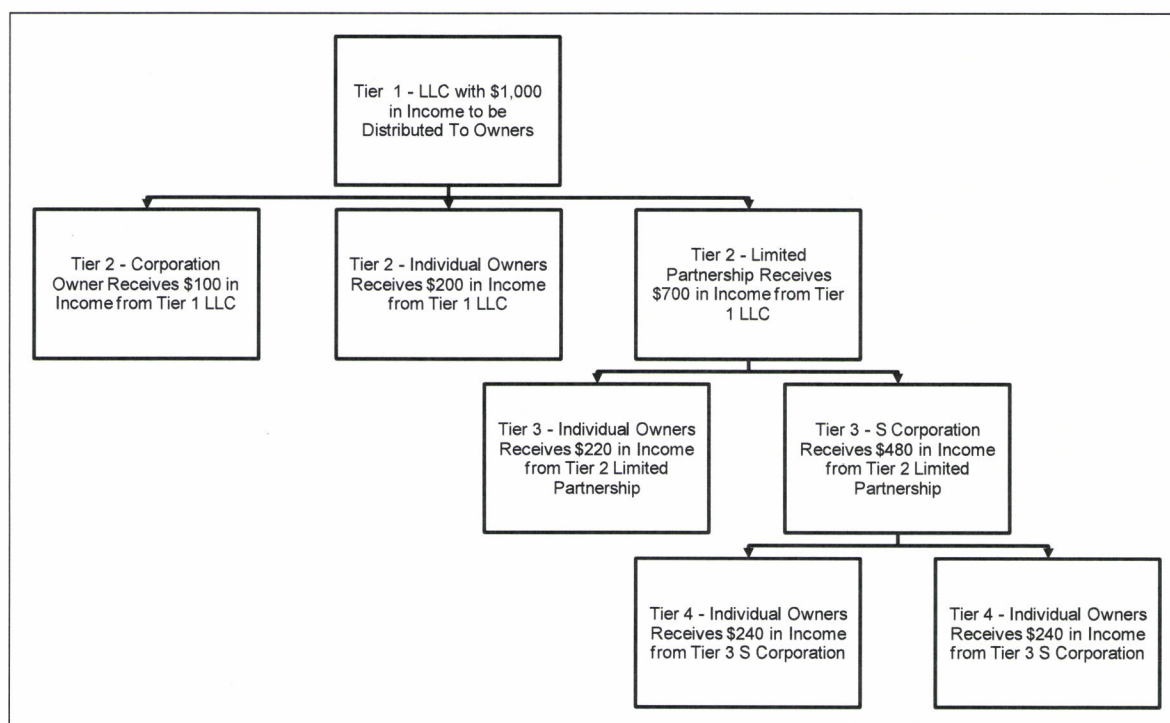


## Tiered Ownership and Tax Administration

Pass-through entities include partnerships; S-corporations; limited liability companies (LLCs); real estate investment trusts (REITs); regulated investment trusts (RITs), better known as mutual funds; and others. Partnerships are an old and familiar business entity, but S-corporations are less so. The S-corporation rules were enacted in 1958 and permit a corporation and its shareholders to elect to be taxed at one level.

The most common type of pass-through entity today is the limited liability company, or LLC. LLCs are actually a creation of the states since state law generally governs business structure. The first LLC statute was enacted in Wyoming in 1977 and now all states and the District of Columbia have LLC statutes. However, for federal tax purposes, federal law governs the tax treatment (states generally follow the federal treatment). For taxation purposes LLCs are generally treated as partnerships, although LLCs with two or more members can elect to be treated as S corporations. Any single member LLC can elect to be treated as a sole proprietorship if the single member is an individual; if the single member is a corporation, then the LLC is treated as a branch by the IRS. The taxpayer must be consistent in its state filing with its federal filing, so if a business filed as an S corporation at the federal level, it must file as an S-corporation at the state level.

A pass-through entity is not itself taxed. Instead, its income and expenses are reported on the tax returns of the owners. The owners can be corporations, individuals, other pass-through entities, or a mix of all of them. When pass-through entities are owned by other pass-through entities, a "tiered" business structure is created.



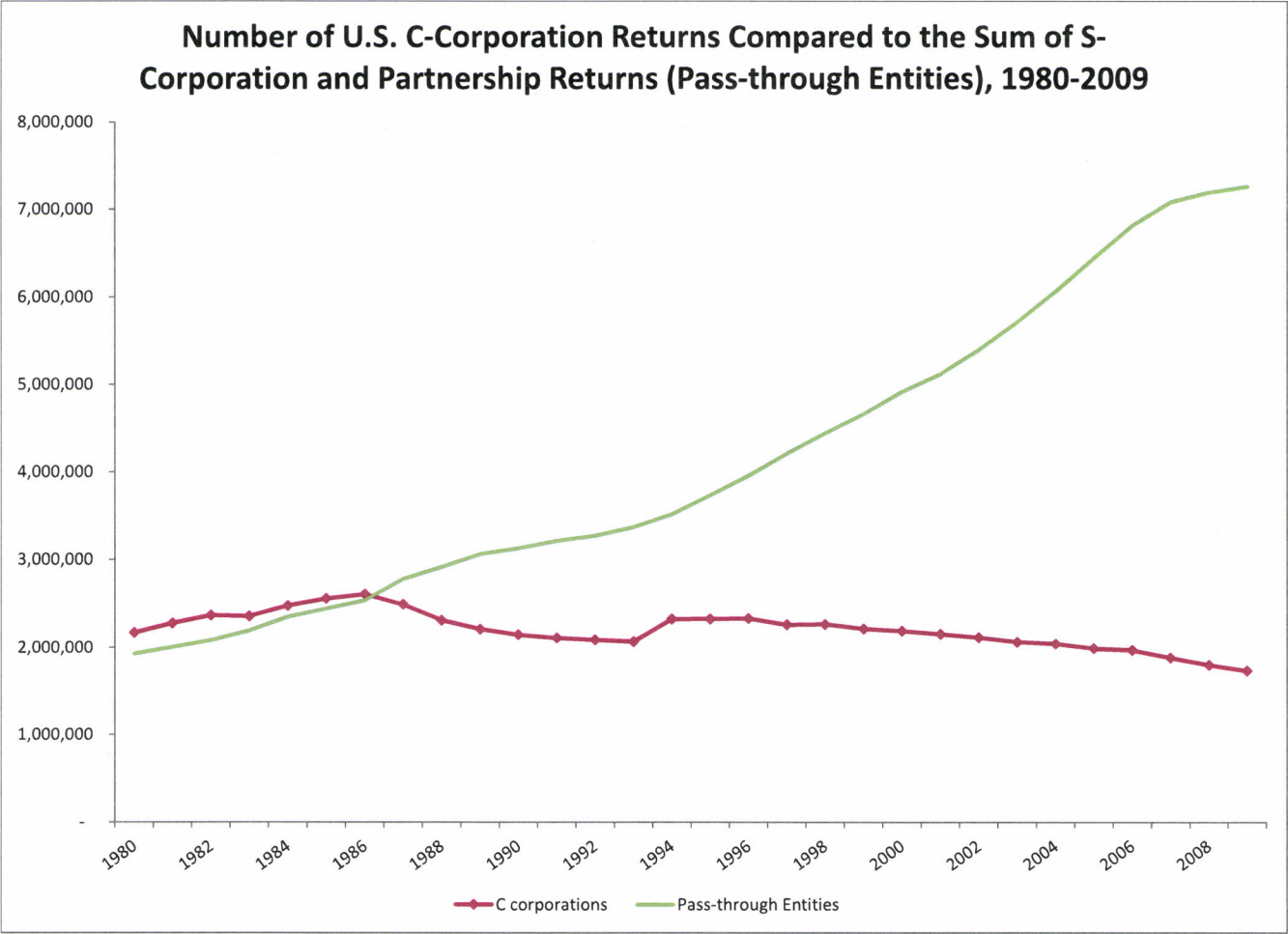
Tiered structures add complexity to tax administration because the "taxpayer" may be quite remote from the entity doing business in the state. Because pass-through entities can have either corporate, individual and/or another pass-through entity as a partner, owner or shareholder, they represent a challenge for tax administration. The diagram above shows how complex even a comparatively small set of ownership/partnership relationships can become.

A pass-through entity with Montana source income must file an informational return. If this entity has a partner, shareholder, member or other owner who is a non-resident individual, foreign C-corporation, or a pass-through entity with an owner/shareholder that is a nonresident individual or foreign C-corporation, the pass-through entity is also required to file with the state an agreement with the individual nonresident to timely file a Montana return, pay taxes and be subject to personal jurisdiction of the state with respect to the income from the pass-through. If this agreement is not met, the pass-through entity must in all subsequent tax years withhold the appropriate amount and remit the tax payment directly to the state (15-30-3313, MCA).

## Growth in Pass-Through Entities

### Growth of Pass-Through Entities

Increasingly, in Montana and nationwide, business and investment activities are being conducted by “pass-through entities.” The graph below shows the number of returns filed with the IRS by regular or C-corporations versus those filed by pass-through entities (partnerships and S corporations) from 1980 through 2009 (the graphs and history in this section are from Selected Issues Relating to Choice of Business Entity, Joint Committee on Taxation, U.S. Congress, July 27, 2012).

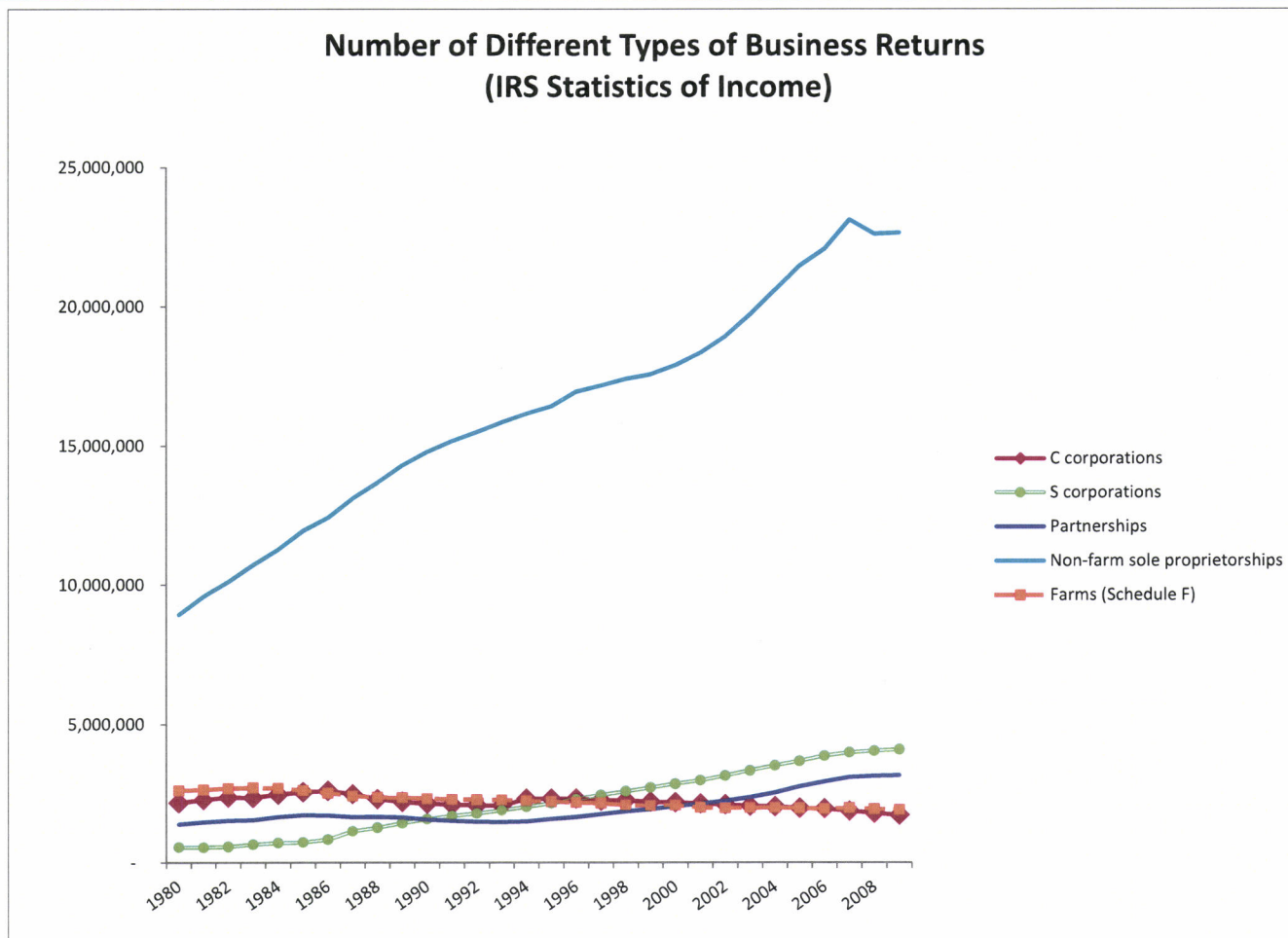


Over time Congress has modified the rules governing pass-throughs, particularly S-corporations, making those business structures more attractive for business purposes. For example the number of permitted shareholders has been expanded from the original 10 in 1958 to 35 in 1982, 75 in 1996, and 100 in 2004, where it remains today.

The graph on the next page shows growth over the same period, 1980 – 2009, of all types of business organizations, including non farm sole proprietorships, S-corporations, partnerships, and farms filing using Schedule F.



## Growth in Pass-Through Entities



As can be seen from the graph, non-farm sole proprietorships are the most common type of business entity in the U.S. based upon the number of returns filed. The number of non farm sole proprietorships has grown substantially – from 9 million in 1980 to almost 23 million in 2009.

Sole proprietorships, just as the name suggests, are businesses with a single owner and are a familiar sight on many Main Streets in Montana. The Department of Commerce in its publication, *Economic and Demographic Analysis of Montana*, December 2007 reported that over 60 percent of Montana businesses are sole proprietorships without any employees. The owner of a sole proprietorship will record his or her income on the state individual income tax form, Form 2 on line 12 as Business Income (or loss), and will attach a copy of federal Schedule C (or C-EZ), which has been filed with the taxpayer's federal tax return.

If the business owner has a farm or ranch operation that is operated as a sole proprietorship, the taxpayer reports his or her income on line 18 of the state individual income tax form (Farm Income or (loss)), and attaches a copy of federal Schedule F, which has been filed with the taxpayer's federal form. The number of farms filing under schedule F is also shown on the graph. The total number of farms in the US filing schedule F went from 2.6 million in 1980 to 1.9 million in 2009. However it should be noted that farms can also operate as partnerships or be incorporated as S-corporations or C-corporations.



## Growth in Pass-Through Entities

During the same period, the number of C corporation returns declined, going from 2.2 million corporations in 1980 to 1.7 million in 2009. One thing to note is that C corporations in Montana seem to vary greatly in terms of size – there are large or very large businesses which engage in operations across many states and even countries, but there are also smaller firms that engage in agricultural operations, are Main Street businesses, or regional operations. Some of these corporations may have been incorporated before the S-corporation structure was available; others may have been incorporated as C-corporations in order to be better positioned to access capital markets, or for one or more of the advantages that C-corporation status provides.

The number of businesses that filed as S-corporations has also grown very rapidly during the same time. The IRS data shows the number went from 545,000 in 1980 to over 4 million in 2009, an annual growth rate of over 7 percent. Partnerships grew more slowly – increasing from 1.4 million in 1980 to 3.2 million in 2009.

Although not shown on the graph, less common types of pass-through entities also increased over the last three decades. These include real estate investment trusts (REITs) and regulated investment companies (RICs), better known as mutual funds, going from 1,691 returns in 1980 to 14,778 returns in 2009.

***Businesses of all sizes can be C-corporations or pass-through entities. Sole proprietor businesses generally are small. For 2008, the IRS reports that average receipts were \$4.9 million for C-corporations, \$1.9 million for partnerships, and \$1.5 million for S-corporations, but only \$58,000 for sole proprietor businesses. Many sole-proprietor businesses are part-time or a sideline for the owner. For 2011, 95% of taxpayers whose Montana income tax returns showed income or loss from a sole-proprietor business reported more income from other sources.***

### Ownership, Income, Deductions and Credits Reported on Montana Pass-Through Returns

Pass-through entities classified as S-corporations or partnerships for tax purposes are required to file an information return each year. These information returns show the total amounts of various types of income, deductions, and credits allocated to the owners and the amount distributed to each owner. Pass-through entities operating in more than one state apportion part of their income to Montana using the same apportionment formula as C-corporations. Pass-through returns show the Montana-source income allocated to each owner and indicate whether each owner is an individual or another business entity.

Owners of pass-through entities taxed as partnerships may be either individuals or business entities. Shares of S-corporations can only be owned by individuals, electing small business trusts or employee stock ownership plans. However some types of pass-through entities that can be owned by other business entities can elect to be treated as S-corporations for tax purposes. The following table shows the number of owners and the amount of income allocated to owners. This table shows information separately for owners who are resident and non-resident individuals and Montana and non-Montana business entities (based upon the business address provided).

Shares of Pass-Through Income by Owner Type				
Type of Owner	Number	%	\$ millions	%
Resident Individuals	71,806	33%	\$1,361.90	62%
Non-Resident Individuals	92,423	43%	\$404.60	18%
Montana Business Entities	9,080	4%	\$160.60	7%
Non-Montana Business Entities	42,632	20%	\$275.90	13%
<b>Total</b>	<b>215,941</b>	<b>100%</b>	<b>\$2,202.90</b>	<b>100%</b>



## Ownership, Income, Deductions and Credits Reported on Montana Pass-Through Returns

As can be seen in the table above, pass-throughs filing informational returns in Montana reported having 92,423 non-resident individuals as owners with Montana source income of nearly \$405 million in 2010. Resident individuals are the second largest group of owners who show up on the pass-through returns (71,806 or 33 percent of all owners) with a reported \$1,361.9 million in Montana source income. Just over nine thousand Montana business entities were listed as owners by pass-throughs on the informational returns, but more than 42,000 non-Montana business entities were owners of pass-throughs with Montana source income. The Montana business entities had \$160.6 million in Montana source income; the non-Montana business entities had \$275.9 million in Montana source income.

The next table in this section shows information from the same group of pass-through returns as in the table above, but splits the data into what was reported by S-corporations and what was reported by partnerships.

Montana Source Income by Type of Owner, 2010 Includes Income Allocated from First-Tier to Second-Tier Pass-Throughs (\$ million)								
Type of Owner	S-Corporations				Partnerships			
	Montana		Multi-State		Montana		Multi-State	
	Owners	Income	Owners	Income	Owners	Income	Owners	Income
Resident Individuals	31,341	\$733.7	4,525	\$266.9	34,015	\$321.6	1,925	\$39.7
Non-Resident Individuals	3,147	-\$1.8	15,357	\$388.0	11,005	-\$73.3	62,914	\$91.7
Montana Business Entities	2,288	\$10.3	296	\$18.6	6,166	\$113.9	330	\$17.7
Non-Montana Business Entities	113	\$21.5	2,224	\$17.3	3,265	-\$211.9	37,030	\$449.0
<b>Total</b>	<b>36,889</b>	<b>\$763.7</b>	<b>22,402</b>	<b>\$690.8</b>	<b>54,451</b>	<b>\$150.3</b>	<b>102,199</b>	<b>\$598.1</b>

Net income from a pass-through entity's business operations is usually allocated to the owners as ordinary business income. Individual owners report this income on Schedule E of their federal tax returns and then report income from Schedule E on Line 17 of the Montana tax return. Income the pass-through entity receives from passive investments or the sale of assets is allocated to the owners as that type of income, and owners report it on the corresponding lines of their tax returns. For example, if a pass-through entity receives \$1,000 of interest and allocates it equally to its 10 owners, who are Montana individuals, each owner should report the \$100 of interest on Line 8a of their Form 2.

In both tables above, there are Montana and non-Montana business entities that have ownership shares in both partnerships and S-corporations. When there is tiered ownership - meaning one pass-through entity is a full or part-owner of another - both entities will include the income the first-tier entity allocates to the second-tier entity in their returns. The following table shows the number of returns, types of income, Montana adjustments to income, and deductions that were passed through to owners in 2010. Income and other items passed through two or more entities are only counted once.